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MEMORANDUM TO DIRECTORS OF PERSONNEL

Subject: Legislative Developments Affecting Income Tax on Federal Annuities

From: James W. Morrison, Jr.  
Associate Director  
for Compensation

In its deliberations on the pension and deferred compensation provisions of the tax reform proposal, the Committee on Ways and Means of the House of Representatives has proposed a change in the way that retirement benefits to Federal annuitants and others are treated for income tax purposes. This memorandum will bring you up to date on the status of the proposal and its current provisions.

The Committee has proposed repeal of the current 3-year rule on recovery of the annuity basis. That rule provides a tax-free period of up to three years for an annuitant to recover through annuity payments an amount equal to the amount (basis) contributed from salary to the Civil Service Retirement System during active employment.

If the Committee proposal is enacted, a portion of Federal retirement payments would be subject to income tax from the outset. In effect, the basis recovery would be spread out over an actuarially determined period (perhaps as many as 20 years), and only that portion of annuity attributed to recovery of the basis in a given year would be tax free. Assuming 20 years to be the actuarial life-time expectation for receipt of annuity payments, then 95% of the annuity received in any year would be subject to income tax.

The Committee is now drafting language which would repeal the 3-year rule as of July 1, 1986. Any Federal retiree whose annuity commences before that date would not be subject to the rule change.

I would like to emphasize that the final details of any change in the tax on Federal annuities is still far from known. Employees who are eligible for optional retirement should be cautioned against making precipitous retirement decisions based solely on the proposal of the Ways and Means Committee. Further deliberations in the House of Representatives and the Senate could substantially alter what has been agreed to by the Committee.

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